III. THE CALLS PROPOSAL RESULTS IN RATES THAT ARE ILLEGAL

A. EMPIRICAL ANALYSIS SHOWS THAT THE CURRENT RECOVERY OF COSTS IN THE FEDERAL JURISDICTION IS EXCESSIVE

1. The Principles Articulated by the FCC have Been Upheld in the Courts and Practical Tools for Implementation are Available

In the three and one-half years since the passage of the Telecommunications Act of 1996 the Commission has articulated a paradigm for the estimation, allocation and recovery of costs that faithfully balances the complex goals of the Act. Through a long series of orders in the universal service, local competition, and access charge reform dockets the Commission's paradigm has identified the following essential principles (in order of their magnitude of importance measured by their impact on rates or the size of the universal service fund):

- Forward-looking economic costs must be the basis for establishing prices and universal service support[30]
- The loop is a shared cost – shared by all of the services that utilize it.[31]

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[30] Joint FNPRM

> We agree with the Joint Board that we should use forward-looking costs as a starting point in determining support amounts. We believe that basing support levels on forward-looking costs will send the correct signals for investment, competitive entry and innovation, and that a single national cost model will be the most efficient way to estimate forward-looking cost levels (¶ 11).
>
> We adopt the Joint Board's recommendation that forward-looking economic costs should be used to estimate the costs of providing supported services (¶ 48).

[31] The most explicit statement can be found at Federal Communications Commission, In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges: Notice of Proposed Rulemaking, CC Docket Nos. 96-262, 94-1, 91-213, 95-72, ¶ 237

> For example, interstate access is typically provided using the same loops and line cards that are used to provide local service. The costs of these elements are, therefore, common to the provision of both local and long distance service

- Actual competition is the trigger for action, not theory.[32]

With the development of the Synthesis Proxy Cost Model (SPCM) and a Supreme Court ruling upholding the concept of forward-looking economic costs, the end is in sight. Now is the time to implement the above principles.

The FCC has received substantial evidence that rates should be declining because productivity has exceeded the rate of inflation by a substantial margin for the past decade. The most extensive studies of local costs commissioned by Public Counsels across the country show even higher productivity increases than the Commission found in the interstate jurisdiction.[33] The

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[32] Joint FNPRM.

> Support based on forward-looking models will ensure that support payments remain specific, predictable, and sufficient, as required by section 254, particularly as competition develops. To achieve universal service in a competitive market, support should be based on costs that drive market decisions, and those costs are forward-looking costs. (¶ 50)
>
> The model currently suggests that, using this methodology, a cost benchmark level near the center of the range recommended by the Joint Board would provide support levels that are sufficient to enable reasonably comparable rates, in light of current levels of competition to preserve and advance the Commission's universal service goals. (¶ 99)
>
> We also seek comment on whether we should calculate costs at the study area level. In recommending that the federal support mechanism calculate costs at the study area level, the Joint Board suggested that the level of competition today has not eroded implicit support flows to an extent as to threaten universal service. (¶ 105).

[33] "Rebuttal Testimony of Dr. Marvin Kahn, on Behalf of the Office of the Attorney General," Before the State Corporation Commission of Virginia, <u>In the Matter of Evaluating Investigating the Telephone Regulatory Case No. PUC930036 Methods Pursuant to Virginia Code S. 56-235.5</u>, Cause No. PUC930036, March 15, 1994 and "Prefiled Testimony of David Gable on Behalf of the Indiana Office of Utility Consumer Counselor," Before the Indiana Utility Regulatory Commission, <u>In the Matter of Petition of Indiana Bell Telephone Company, Incorporated for the Commission to Decline to Exercise in Part Its Jurisdiction Over Petitioner's Provision of Basic Local Exchange Service and Carrier Access Service, to Utilize alternative Regulatory Procedures for Petitioner's Provision of Basic Local Exchange Service and Carrier Access Service, and to Decline to Exercise in Whole Its Jurisdiction Over all other Aspects of Petitioner and Its Provision of All Other Telecommunications Service and Equipment, Pursuant to IC 8-1-2.6</u>, Cause Number 39705, January 1994, estimate the productivity offset in the rate of 7 percent per year in the late 1980s and early 1990s.

Commission should consider reductions in the SLC and the universal service package, rather than rate increases.

Now is the time for the subscriber line charge to be eliminated so that the playing field can be leveled for competition. In this way, loop costs would be recovered from two entities, local and long distance companies, who are soon to be competing with one another. Recovering these input costs from suppliers will also place local and long distance companies on an equal footing with other potential providers of loop services. New entrants who provide loop cannot charge consumers a subscriber line charge. Eliminating the subscriber line charge eliminates the wedge between the cost of loop and the costs incurred by the traditional service providers (ILECs and IXCs) who use it.

3. The Failure to Lower the Loop Costs Recovered in the Federal Jurisdiction would be Arbitarty and Capricious

With the legality of forward-looking economic costs as the basis for federal action established and a model for estimating those costs in place, the Commission should move forward by applying that model to all costs in the federal jurisdiction. Indeed, the Commission has already applied this model to loop costs in the high cost proceeding.[34] Although the Commission said in its high cost proceeding that its use of the model there does not require it to apply the model in other proceedings, the CALLS proposal would force the Commission to apply the model in this proceeding.

[34] Large LEC high cost.

The CALLS proposal claims to set switching costs closer to forward-looking economic cost levels.

> To the extent the Commission seeks to set rates based on some measure of cost forward looking cost, itself a matter of debate appropriate cost measures have been particularly difficult to determine. In addition to its origin as a negotiated level, the target rates are within a range of projections that have been suggested as a potential estimate of the economic cost of switched access. Regardless, the targets are clearly closer to forward looking economic costs than current rates.[35]

The level proposed is consistent with the SPCM. To fail to set loop costs at their forward-looking economic levels in this proceeding, when switching costs are being set at that level, would be arbitrary and capricious.

The CALLS proposal makes repeated reference to forward-looking costs and to the various models for estimating those costs.[36] The very same models as described in Exhibit 1, demonstrate that the economic cost of local service is well below claimed embedded costs. The SPCM produces an estimate well within a range of reasonableness. There can be no justification for using the very same models to lower switching costs but not loop costs.

4. Current Cost Recovery In The Federal Jurisdiction Is Excessive

The CALLS proposal is based on an incorrect premise about the subscriber line charge and its relationship to other rates. It assumes, incorrectly, that the current recovery of costs in the federal jurisdiction is inadequate to cover the costs properly assigned to it.

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[35] CALLS, p. 36.

[36] CALLS, pp. 26, 27, 36.

The economic evidence before the Commission shows that the current recovery of costs is excessive. The Commission acknowledges that the Joint Board has not reached a conclusion about the existence of subsidies in the current recovery of common-line revenues.

> The Joint Board, however, made no finding as to whether implicit support exists in interstate access rates, or whether the Commission should make such support explicit if it does exist. (Joint FNPRM, ¶ 42).

We arrive at this empirical result in the following fashion. Exhibit 2 is based on the cost of loop and port as calculated by the SPCM at the wire center level. It shows the cumulative percentage of lines falling below a specific dollar figure.

The statewide average for Texas is $18.22 per month. Since 25 percent of these costs have been allocated to the Federal Jurisdiction, the Federal charges should cover $4.55 per month. Similar estimates for over a dozen states representing almost two-thirds of the lines in the country are presented in Exhibit 3. This analysis shows that Texas is typical of the nation.

Before we estimate how much is collected from residential ratepayers in Texas, there is one observation we would like to make. These data are somewhat old, apparently reflecting 1996 line counts and costs. For example, the data imply that only 4 percent of households have second lines. This would be consistent with 1996 data. By 1997, which is the latest period for which the FCC has data, the percentage on a national basis had increased to about 12 percent.[37] In the 18 months since then, the momentum for second lines has increased. SBC is one of the leaders in selling second lines. For the purpose of this analysis, we use a conservative figure of 20

[37] Federal Communications Commission, Trends in Telephone Service (February, 1999), table 20.4

percent[38] for second lines. This is particularly appropriate since the impact of the FCC decisions that would flow from the instant proceeding will be next year and beyond.[39]

The addition of second lines has a dramatic effect on loop costs. The incremental cost of providing the second line is considerably lower than the first, because most of the capital equipment is deployed. This is especially true of loop and port costs. Consider the following example, which we believe is reasonable. Assume that second line penetration has moved from 4 percent to 20 percent. This assumption is supported by a recent national survey that indicated 24 percent of respondents have a second line.[40] Further assume that the second line costs half as much as the first line. This is a conservative assumption supported by testimony before the FCC and the cost model itself. The statewide average cost for loop and port in Texas would decline from $18.20 to $16.60. In other words the average cost recovery in the federal jurisdiction should be closer to $4.15.

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[38] *See* Application of Southwestern Bell Telephone Company for Rate Group Reclassification Pursuant to Section 58.058 of the Texas Utility Code, (Jan. 26, 1999), General Counsel Exhibit No. 1 at pg. 23. SWBT indicates that improved marketing of additional [second] phone lines resulted in sales which accounted for approximately 14% of new access line in 1993, 18% of new access lines in 1994, 25% of new access lines in 1995, and 29% of new access lines growth in 1996, in Texas. A recent national survey conducted for Joint Consumer Commentors indicates that 24 percent of respondents have more than one line. This is consistent with the assumed 80% primary and 20% non-primary lines.

[39] Trends, Table 20.4, gives year end figures of 114.4 million for residential loops and 17.9 million for additional lines. The figure of 20% for year end 1999 is derived from setting second lines at approximately 25 million and total lines at 123 million. This acceleration of second lines is consistent with the acceleration in Texas as noted in footnote 8.

[40] The October 1999 national survey was conducted by Opinion Research Corporation for Joint Consumer Commentors. The results of this survey are discussed in the Reply Comments, In the Matter of Low-Volume Long-Distance Users, CC Docket No. 99-249 (October 20, 1999).

If the Commission implements its decision to utilize forward-looking economic costs and treat the loop as a common cost, it must conclude that fixed end-user charges (*i.e.*, the subscriber line charge and the PICC) should not be increased but decreased.

- Based upon the results of the default runs of the Synthesis Cost Proxy Model for Texas, we conclude that at least 80 percent of residential lines in Texas are covering 100 percent of the forward looking economic costs of loops and ports (*i.e.*, the non-traffic sensitive portion of costs) that are allocated to the Federal jurisdiction.

Exhibit 4 presents our estimate of the amount collected from residential customers for access in the federal jurisdiction. We assume that 80 percent of the lines in the state are first lines and that 20 percent are additional lines. Based upon the estimates provided by the CALLS, we estimate that in excess of $6.00 per residential account is being collected for access – including the SLC, the PICC and the CCL. In addition, about $2 billion of high cost support is already being recovered in the federal jurisdiction. Since the above analysis looks at average loop costs, that include high cost support, this adds another $.25 to $.50 per month to the overrecovery of costs.[41]

The charges exceed the costs that should be recovered for the vast majority of residential lines in Texas. The federal charges should cover $4.15 to $4.55 per month. However, the federal jurisdiction is collecting over $6.00 per residential account. In other words, based on forward-looking economic costs, the federal jurisdiction is overrecovering $1.50 to $2.00 per month from residential consumers.

[41] The CALLS proposal seeks to "settle" the question of subsidies in other rates at the level of $650 million. This works out to about $.21 per line. In the debate over subsidies, estimates run as high three times that level.

Texas is used as an example because it is a large state that is very close to the national average in forward-looking costs. We reach similar conclusions for other states as well (*see* Exhibit 3). These results show that between three-quarters and nine-tenths of the residential customers already cover the loop costs allocated to the federal jurisdiction. There are a few instances of high-cost states in which a much smaller percentage of the residential customers cover the costs allocated to the federal jurisdiction. That is an issue to be addressed by high cost fund policy.

In summary, over-recovery of costs falls in the range of $1.50 to $2.00 per month per residential line. The total falls in the range of $2.25 to $3 billion annually. Instead of increasing the bottom-of-the-bill charges by almost $2 billion in the residential sector, charges should be decreasing by $2 to $3 billion.

3. The CALLS Proposal Lacks any Empirical Justification for Increasing the Subscriber Line Charge

The closest that the CALLS proposal comes to offering a justification for the increase in the SLC is to point out that increasing the SLC would simply allow it to catch up with inflation.

> Furthermore, the initial proposed SLC cap of $5.50 is the equivalent, in inflation adjusted terms, of a $3.50 SLC in 1984 dollars, the year the SLC was instituted.[42]

While that would be the arithmetic result, there is no underlying economic justification. Telecommunications costs do not track inflation and never have. Technological progress has made the industry a declining cost industry. Over the period since divestiture, the spread of

[42] CALLS, p. 17.

digital line carrier systems, increasing population densities and the growth of second lines have spurred a dramatic decline in costs.

The FCC has erroneously applied all of the increased productivity to the carrier common line component of the federal cost recovery mechanism since it adopted price cap regulation. This has resulted in a dramatic reduction in usage charges (see Exhibit 5). As a result, the compromise that the FCC struck between recovery of federal costs on a fixed and usage basis has been destroyed. In 1984 when the subscriber line charge was instituted, the costs were split on a 50/50 basis. Today, the fixed charges exceed 80 percent of the total.

It is interesting to note that basic local rates, which are largely determined by loop costs, have not tracked inflation since divestiture. Like the subscriber line charge, they have been essentially flat. In other words, state regulators have recognized the declining cost nature of the industry, to a significant degree. In short, there is no economic justification to increase the SLC and there is strong evidence that the recovery of costs in the federal jurisdiction is excessive.

IV. OTHER ELEMENTS OF THE CALLS PROPOSAL RENDER IT ILLEGAL

At least four other elements included in the CALLS proposal would call into question the fairness and reasonableness of the rates it would impose on the public.

A. ABSOLVING CARRIERS OF THEIR OBLIGATION TO MAKE A CONTRIBUTION TO UNIVERSAL SERVICE

1. The 1996 Act Requires Telecommunications Carrier to Contribute to Universal Service

The CALLS proposal would eliminate the clear requirement in the statute that carriers make a contribution to universal service. It shifts the entire cost of universal service onto end users. The federal statute makes no provision for the federal government to recover telecommunications service provider contributions for universal service from ratepayers in the form of a line item surcharge on ratepayers' bills. The federal statute is quite clear that it is telecommunications service providers who must contribute

> **Sec. 254.** (d) Telecommunications Carrier Contribution - Every telecommunications carrier that provides interstate telecommunications services shall contribute, on an equitable and nondiscriminatory basis... .
>
> **Sec. 254.** (f) STATE AUTHORITY - A state may adopt regulations not inconsistent with the Commissions rules to preserve and advance universal service. Every telecommunications carrier that provides intrastate telecommunications services shall contribute.

If subscribers are forced to pay a line item surcharge then telecommunications service providers are not contributing, as required by the Telecommunications Act of 1996. Claims that only a line item on a consumer's bill can meet the requirement that universal service is explicit is a thinly veiled effort to avoid the responsibility the law placed on telecommunications service providers. If a telecommunications service provider is assessed a contribution explicitly to be paid to a universal service fund administrator and pays no other universal service support in any of the prices it is charged, then the funding is explicit. The law does not say funding must be explicit to the customer, it says it must be explicit to the service provider.

As long as all providers are assessed a fair share of the costs of universal service in an explicit rate element, the requirements of the statute will be met. Assessing providers allows them to decide how to recover the universal service costs. Some might pass it through in the form of usage charges. Some might pass it through in the form of customer charges. Still others might not pass it through in an effort to gain market share.

The FCC recognizes this dynamic process in earlier ruling in this proceeding.

> As telecommunications carriers and providers begin merging telecommunications products into single offerings, for example package prices for local and long distance service, we anticipate that they will offer bundled services and new pricing options. Mandating recovery through end-user surcharges would eliminate carrier's pricing flexibility to the detriment of consumers...
>
> In addition, we agree with the state Joint Board members that an end-user surcharge is not necessary to ensure that contributions be explicit. We find that basing contributions on end-user telecommunications revenues satisfies the statutory requirement that support be explicit because carriers will know exactly how much they are contributing to the support mechanism...
>
> As competition intensifies in the markets for local and exchange services in the wake of the 1996 Act, it will likely lessen the ability of carriers and other providers of telecommunications to pass through to customers some or all of the former's contribution to the universal service mechanisms. If contributors, however, choose to pass through part of their contributions and to specify that fact on customer's bills, contributors must be careful to convey information in a manner that does not mislead by omitting important information that indicates that the contributors has chosen to pass through the contribution or part of the contribution to its customers and that accurately describes the nature of the charge.[43]

[43]FCC, Universal Service Order, paras. 853, 854, 855.

1. Claims that the 5th Circuit Ruling Requires a Line Item on End-Users Bills are Incorrect

Some CALLS proponents have asserted that the 5th Circuit decision, Texas Office of Public Utility Counsel v. FCC[44], require that ILEC USF contributions must be recovered through end user surcharges. However, that interpretation of the 5th Circuit decision misstates the Court's holding and fails to reconcile that Court's decision with the decision[45] of the 8th Circuit on the same issue.

First, sec. 254(e) simply states that universal service support "should be explicit." The 5th Circuit panel concluded that the FCC violated that provision because the agency required ILECs to recover the costs of their contributions to the universal service fund through access charges. The panel did not conclude that only an end-user surcharge would satisfy sec. 254(e)'s explicitness requirement, because that issue was not before the Court. Rather, the panel found that the FCC cannot mandate an implicit method of cost recovery.

In fact, the Court is clear that it is focusing on mandatory USF recovery issues when it states, "[b]y forcing GTE to recover its universal service contributions from its access charges, the FCC's interpretation maintains an implicit subsidy for ILEC's such as GTE."[46]

The commenters' argument also fail to harmonize this holding with the 8th Circuit's decision in Southwestern Bell Telephone Co. v. FCC, 153 F.3d 523 (8th Cir. 1998). In that case,

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[44] Texas Office of Public Utility Counsel v. FCC, 1999 WL 556461 (5th Cir. July 30, 1999).

[45] Southwestern Bell Telephone Co. v. FCC, 153 F.3d 523 (8th Cir. 1998).

[46] *Id.* (emphasis added).

on the same issue, the 8th Circuit held that sec. 254(e) did not preclude the FCC from permitting ILECs to recover USF contributions through interstate access charges. The 8th Circuit held:

> We cannot agree that allowing LECs to recoup from their interstate customers the normal costs of providing telecommunications services to those customers amounts to creating a discriminatory implicit subsidy. As the FCC points out, mandatory contributions to the new universal service fund are real costs of doing business that will be incurred by both LECs and IXCs. The agency determined that "[u]nder our recovery mechanism, carriers will be permitted, but not required, to pass through their contributions to their interstate access and interexchange customers." Universal Service Order ¶ 829.
>
> Under this scheme, IXCs have the option of recovering their universal service contributions through rates to their long-distance customers. LECs have the same option of passing on the costs of contributions to their interstate customers--both end users and IXCs. See Order ¶ 379.
>
> Access charges imposed on IXCs that include the LECs' universal service cost are not "above cost" since universal service contributions are a real cost of doing business. The flow-through of LEC universal service costs to its IXC customers is akin to the flow-through of IXC universal service costs to its long-distance customers--neither can be categorized as an implicit subsidy in violation of § 254(e).

Id. at 553-54.

Failing to harmonize both Circuits' decisions misinterprets the current state of the law surrounding sec. 254(e). When both decisions are harmonized it is evident that IXCs and LECs have the discretion to determine whether these costs of doing business are flowed-through to their customers or not. There is no legal requirement that they do so, and certainly no legal requirement that the recovery of the cost should be an end-user surcharge. In any event, 254(e) concerns explicitness of support flowing from the USF and not contributions to the fund.

B. THE CALLS PROPOSAL WOULD UNDERMINE THE COMMISSION'S ABILITY TO ENSURE THAT RATES ARE JUST AND REASONABLE

1. Abandoning the Audit

The CALLS proposal purports to settle the dispute over the audit of LEC accounting records which revealed substantial irregularities. The FCC found that assets that were on the books could not be accounted. These phantom assets are associated with costs that have been imposed on consumers. Yet, the CALLS proposal makes no adjustment in rates to take account of the unjustified charges levied on consumers. There is no reason that consumers should be required to pay for assets that do not exist. Indeed, to the extent that these phantom assets have depressed the apparent overall rate of return of the LECs, consumers have been overcharged.

The Commission cannot simply ignore the audit. To do so would force consumers to pay rates that are not just and reasonable.

2. Abandoning the Productivity Factor

The CALLS proposal eliminates the productivity factor. The productivity factor is the key element in the Price Cap regulatory regime that ensures that rates are just and reasonable. If costs decline as a result of increases in productivity in an environment in which competition is not in effect, and there is no productivity factor to ensure that rates follow costs, excess profits will be earned. Consumers would be charged rates that exceed those which would prevail in a competitive market because neither competition nor regulation will require incumbent LECs with market power to share the fruits of increasing productivity. The practical experience since the creation of the price cap regime is that productivity increases have been substantial. There is every reason to believe they will continue into the future, especially considering the growth of second lines and increasing call volumes. Thus, the failure to include a productivity factor will result in substantial overcharging of consumers.

The market for exchange access has not been found by the Commission to be effectively competitive, nor could it be. Indeed, the Commission has not even found any local market to be irreversibly open. If the Commission eliminates the productivity factor on the mere hope that this market will be competitive at some time in the future, it will be unable to demonstrate that the resulting rates exclude excess profits. Such an action would result in rates that are unjust and unreasonable.

3. Creating an Automatic Mechanism for Increasing Rates

The mistreatment of consumers in the CALLS proposal goes even farther. There would appear to be up escalators, to protect the LECs from inflation, but no down escalators to share in productivity increases. The LECs are allowed to increase rates when costs rise but they are not required to decrease rates when they fall. This scheme is clearly unjust.

V. INCREASING LINE ITEMS UNFAIRLY BURDENS LOW-VOLUME AND LOW-INCOME RESIDENTIAL CONSUMERS

A. PREVIOUS ANALYSES OF THE IMPACT OF RATE RESTRUCTURING ON RESIDENTIAL CONSUMERS

1. Universal Service

In previous comments filed before the Commission in three of the four proceedings identified in the caption for this docket, Joint Consumer Commentors have addressed the distributive impact of proposals to increase line items on consumers' bills. The evidence continues to mount that such a shift is highly regressive, increasing the burden on lower- and middle-income households, while reducing the bills of upper-income households.

In comments filed in the Federal-State Join Board Universal Service proceeding, Texas OPC filed comments urging the FCC to reject the regressive proposal by the industry, *inter alia*, to increase the SLC:

> The proposals by SWB and GTE drive a wedge between the rate reduction for non-core services and the rate increase for core services by adding surcharges directly to customer's bills. Claims that customers will see lower bills or be economically better off are doubtful in light of the surcharges, which would add as much as $5 per month to individual bills.
>
> Even if rates for non-core services are lowered in an amount equal to the aggregate increase in core services, the distribution of the rate increases and decreases will not be even. The explicit purpose of rate rebalancing is to shift costs away from intensive users of the network. It is not surprising to find that lower income groups will receive a disproportionately smaller share of the benefits and pay a disproportionately large share of the costs of rate rebalancing, since the are much less intensive users of the network. Similarly, large business users will receive more benefits than residential ratepayers.[47]
>
> ...
>
> Assuming revenue neutral, across-the-board rebalancing results in net increases in bills for the poorest households and net decreases in bills for the richest. ... The households that suffer the net increase in their bills are the most in need. National numbers indicate that they are likely to be households headed by persons under 25, persons over 65, and females.[48]

[47] Texas OPC, Reply Comments, In the Matter of Federal-State Joint Board on Universal Service, Docket No. 96-45 (May 7, 1996) at pp. 21-22.

[48] Texas OPC, Reply Comments, In the Matter of Federal-State Joint Board on Universal Service, Docket No. 96-45 (May 7, 1996) at pp. 22-23.

In Reply Comments[49] filed over two years ago, Texas OPC analyzed the distributional impact of a proposed $3.33 increase in the subscriber line charge. This is almost exactly what the CALLS proposal suggests. Sprint's data clearly demonstrated that lower-income and low-volume households would bear a disproportionate share of the burden. The evidence presented is consistent with all that has followed. Because it was generated by a company and involves an increase in the SLC close to what is on the table in the CALLS proposal, we quote extensively from that analysis. Everything we have seen leads us to believe it is right on point.

> **'Under Sprint's regressive proposal, low income households will spend a larger percentage of their income to pay for the increase in the SLC, alone, than households with incomes above $75,000 will pay for their entire telephone bill, including the increase in the SLC.**
>
> Sprint offers assurances that price increases for basic service will be offset by price reductions elsewhere, caused by market forces.
>
> However, Sprint's use of qualifiers such as increases "may" be offset, or that the burdens of increases in "many"[50] cases will be offset by price reductions is critical.
>
> Sprint offers no guarantee of any rate reductions. At most, it argues that competition will lower rates for services with higher elasticities of demand.
>
> In its Universal Service comments, Texas OPC challenged these claims. The claim that the long distance market is sufficiently competitive to compel price decreases is arguable at best.
>
> Sprint acknowledges that the local market is not currently sufficiently competitive to be relied upon to impose pricing discipline.

[49] Texas OPC, Reply Comments, <u>In the Matter of Access Charge Reform</u>, Docket No. 96-262, (February 14, 1997).

[50] *See e.g.*, Sprint's quote on page 5 of these comments.

Even for long distance services, the elasticities of demand it cites are by no means high. In fact, the overwhelming majority of non-basic revenues come from services with elasticities of demand that are inelastic (less than one) and therefore not subject to significant downward pressure on pricing.

...

Only if the offset of basic and long distance price changes are equal would residential ratepayers not be harmed. In fact, this is not likely to happen.

Raising basic monthly rates falls most heavily on low volume users, while price reductions are to the benefit of high volume users. If Sprint passes through the rate reductions in proportion to usage, the burden on low volume users outweighs the benefit many times. The most likely losers will be residential consumers and small businesses which make no long distance calls.

To the extent that prices are reduced for residential customers, the reductions are more likely to go to upper income households than low and middle income households. Even if price reductions were passed through evenly, households with incomes above \$50,000 would receive approximately 50 percent more than households with incomes below \$20,000 and 30 percent more than households with incomes between \$20,000 and \$50,000.

The previous two analyses can be combined to estimate the incidence of Sprint's proposed \$3.33 increase in the SLC on residential ratepayers at various income levels. Assuming a proportionate pass through, approximately 30 percent of the reduction in costs goes to multi-line businesses. The remainder is spread among the income groups in proportion to their consumption of long distance services.

[A]ll groups are worse off, except the highest income group. Very high users in any income group would save, but the vast majority of consumers would be worse off, particularly lower income consumers... For households with incomes below \$10,000 for every dollar increase in the SLC, they are likely to have a net increase in their bill of \$.50. Up through the middle class, every dollar increase in the SLC is likely to result in net bill increases of \$.33. This is truly a case of trickle up economics.

Moreover, given the distribution of revenues, Sprint is unlikely to pass through any cost reductions equally to all customer groups. Sprint is more likely to target its price cuts to its high volume customers. Contrary to Sprint's claims, basic long distance rates have not been tracking access charges. Since 1990, access charges have declined by 15 percent, but interLATA long distance rates are up by

15 percent. The targeting of discounts has resulted in increases in basic long distance rates in the past several years.[51]

2. Low-Volume Consumer Bill Analysis

In more recent filings of the Joint Commentors in response to the Notice of Inquiry on Low-Volume Residential Long Distance Users (low-volume proceeding) it has again been demonstrated that increasing line items on the bottom of the bill have a disproportionately negative effect on low-volume households who tend to be lower income households.[52] The evidence presented in that proceeding ends any question about the general impact of these charges.[53] Analysis of actual bills and price indices shows that the increase in fixed charges has resulted in increased phone bills for the majority of residential long distance customers. The FCC's own bill analysis presents stunning testimony to the impact on low volume users (see Exhibit 6). The evidence in the low-volume users proceeding can be summarized as follows:

- Well over half and perhaps as many as two-thirds of all residential customers have experienced an increase because the reduction in per minute charges for usage has not been large enough to offset the increase in bottom of the bill charges.
- Thus, between 50 and 70 million households have been adversely affected.

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[51] Texas OPC, Reply Comments, In the Matter of Federal-State Joint Board on Universal Service, Docket No. 96-45 (May 7, 1996) at pp. 10-11, 13-15.

[52] See generally, Joint Comments of CFA, CU and TXOPC (Sept. 21, 1999) and Joint Reply Comments of CFA, CU, and TXOPC (Oct. 20, 1999), In the Matter of Low-Volume Long Distance Users, Docket No. 99-249.

[53] The following Comments, all filed on September 22, 1999, provide the industry's substantive analysis of pricing – *Comments of AT&T* (hereafter AT&T) in particular Exhibit 1, which is *Declaration of Gregory L. Rosston* (hereafter Rosston); *MCI Worldcom, Inc., Comments* (hereafter MCI) and an attached paper by George S. Ford entitled *An Economic Analysis of the FCC's Notice of Inquiry on Flat Rate Changes in the Long Distance Industry* (hereafter Ford), as well as a paper by Robert W. Crandall entitled *Telephone Subsidies, Income Redistribution, and Consumer Welfare* (hereafter Crandall), which was attached to comments of the United States Telephone Association.

Much of the debate in the low-volume proceeding turns on whether low-volume consumers can effectively avoid the minimum bill requirements recently imposed by the dominant firm in the long distance industry. Data presented in a CALLS sponsored study in this proceeding make it absolutely clear that the vast majority of very low-volume customers are not avoiding those charges.[54] We note that the minimum usage requirement is not an issue in the CALLS proceeding, since the purpose of the CALLS proposal is to transform the PICC and USF charges into line items so that all consumers are forced to pay them.

Claims by interexchange companies (IXCs) that long distance rates are "the lowest they have ever been"[55] are true only if the analysis includes business rates and excludes the bottom-of-the-bill charges paid by residential customers. In other words, these claims are false if one looks at the actual bills paid by residential customers, which is the focus of the recent low-volume proceeding.

Low-income consumers are disproportionately low volume consumers. Therefore, low-income, low-volume consumers are hardest hit by these new pricing schemes. Assertions that there is "virtually no correlation between income and low-volume long distance usage"[56] or that the relationship is "very weak"[57] and therefore that the bottom of the bill increase "does not have

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[54] For example, APT states that 5% of end users do not select a presubscribed interexchange carrier (p. 7)." This means that 5 million accounts have avoided the PICC and minimum bill charges. Our estimate is that 15 million accounts place no interlata, interstate long distance calls in a given month. Another 10 million fall below the level of usage required by the minimum bill requirement.

[55] MCI Comments, In the Matter of Low-Volume Long Distance Users, Docket No. 99-249 (Sept. 21, 1999), p. 3.

[56] *Id.* AT&T Comments, p. 3.

[57] *Id.*, MCI Comments, p. 9.

a material impact on low-income users as a group"[58] are simply wrong. Low-income consumers are much more likely to be low volume consumers and to have suffered a significant increase in their long distance bills.

- About 70 percent of the poorest Americans have suffered a net increase in their bills as a result of recent rate restructuring.
- About 60 percent of the wealthiest Americans have enjoyed a net decrease in their long distance bills.

Thus, the conclusions presented in our low-volume analysis apply directly and with even more force to the analysis of the impact of the CALLS proposal.

B. ANALYSIS OF THE IMPACT OF THE CALLS PROPOSAL

1. APT's Flawed Analysis

The study sponsored by APT and paid for by CALLS that purports to show that consumers are better off as a result of the CALLS rate restructuring proposal is simply wrong because it is based on an assumption about long distance pricing that is contrary to actual practice in the industry. It assumes that long distance companies will pass their reduction in access charges through to usage rates on a uniform basis. All consumers, regardless of their level of usage are projected to receive the same reduction in usage rates.

Ironically, even if one assumes a uniform pass through, *i.e.*, there is no price discrimination, the analysis shows that approximately 85 percent of the so called consumer benefit goes to businesses and wealthy people (see Exhibit 7). The APT analysis concludes that over three-quarters of the benefit would accrue to businesses ($4.1 billion out of $5.3 billion). It should also be stressed that these businesses are not single-line businesses.

APT tries to obscure the fact that upper-income households make many more long distance calls than lower-income households by including local bills in its analysis of the distribution of the impact of the CALLS proposal. The wealthiest one-fifth of the population, roughly equal to those with incomes above $75,000 per year, would capture close to 30 percent of the benefits in the residential sector, or $.35 billion out of APT's projected $1.2 for residential consumers.[59] Thus, $4.45 out of the total $5.3 billion goes to businesses and wealthy households.

2. The Real World Impact

More importantly, there is no reason to assume uniform pass through. That is not the historical practice of the industry that has clearly targeted any such reductions to high-volume users. There is no commitment in the CALLS proposal to pass those reductions through in such a manner. In fact, the CALLS proposal only offers to "discuss with the commission" the matter of the aggregate amount of the pass through.

It is much more reasonable to assume that the half-a-penny reduction in access charges will disappear into the black hole of average revenue per minute calculations the IXCs use to attempt to persuade the FCC into thinking that they have passed through the cost savings. The reality for 70 million consumers with interstate usage below the mean is that, under the CALLS

[58] Id., AT&T Comments, p. 3; MCI Comments, p. 10.

[59] The 1997 PNR data provided by MCI indicates 27 percent, but the income data is not properly reported. The PNR data provided by Crandall indicates over 30 percent.

proposal, they will suffer an increase in the bottom-of-the-bill charges of about $1.2 billion. Given historical pricing patterns, they will suffer a net increase in their bills of at least $1 billion (see Exhibit 8).

We arrive at this estimate as follows. The APT study shows that the bottom-of-the-bill charges for primary lines go up about $1.41 per month. We believe that little, if any, of this will be offset. Consider what happened in 1998 when the IXC's added about $2 to the bottom of the bills for PICC and USF charges. Assuming that everyone switched to the most attractive discount plan available at their level of usage, average charges went up for households up to about 120 minutes of use.

More importantly, they went up substantially for households with usage below 75 minutes. Exhibit 8 shows that based on that experience, we would expect these consumers to bear virtually the entire burden of the bottom of the bill increase. Even assuming that all of the households on lifeline rates fall into this group, the total would be above $1 billion.

This likely increase in the total bill that would result from the CALLS proposal stands in sharp contrast to what should be happening if the FCC were to implement its forward looking cost analysis. These 70 million households have about 82 million lines.[60] The federal recovery of costs from them should be reduced by between $1.5 to $2 billion.[61]

[60] The Joint Consumer Commentor national survey indicated that 17 percent of households with usage below the average have more than one line. This is compared to 40 percent of those with usage above the average.

[61] 82 million x $1.5 per month x 12 months = $1.5 billion; 82 million x $2 per month x 12 months = $2 billion .

2. Fixing Problems that Never Should Have Been Created

The CALLS proposal can legitimately claim to solve some problems. Unfortunately, these are very recent problems that have been created by the FCC and the long distance industry and the solution is extremely costly.

For example, the CALLS proposal would exempt consumers receiving Lifeline rates from the PICC (because it would be rolled into the SLC that the FCC waives for these subscribers). Thus, while about 5 million households would not pay the PICC, the remaining 95 million would. The PICC never should have been put on consumers' bills in the first place. In order to save low-income consumers about $100 million per year, the rest of the residential class is stuck with a charge of $1.7 billion. Joint Consumer Commentors are among the strongest supporters of the Lifeline program, but we believe there are better ways to accomplish this goal.

Similarly, the CALLS proposal would eliminate the distinction between first and second lines. That distinction never should have been made. The solution should not be to raise the tax on first lines, it should be to lower it on second lines.

3. The Bottom Line on Bottom-of-the-Bill Charges

The APT methodology is not well described and there are some "adjustments," so the actual impact could be larger. The important point is that if one recognizes the pattern of price discrimination in the industry, one must conclude that the majority of consumers will end up with a higher bill -- and the amount is substantial. Moreover, the bottom-of-the-bill charges mandated by the FCC will grow to alarming levels.

We believe that there will be a charge in the neighborhood of $8 per month per line. This would be composed of over $6 per month for the SLC/PICC and just under $2 per month for universal service.[62] At $8 per month, residential lines generate $12 billion in CCL+USF funds as bottom-of-the-bill charges. This would be an increase of about $5.50 per line or a total of over $8 billion in bottom-of-the-bill charges since the 1996 Act was passed.

C. DEAVERAGING AND DISCRIMINATORY PRICING WILL MAKE MATTERS WORSE, NOT BETTER

The CALLS proposal to deaverage rates is inconsistent with actual market practices and social policy as embodied in the Act of 1996, and is unnecessary if the Commission reforms the SLC in the proper fashion.

The notion that every product is sold at some deaveraged price in the market is simply wrong. Many goods are sold at uniform prices in spite of significant variations in cost. The result is not a subsidy, but a differential mark-up. Any effort by the Commission to deaverage prices will result in massive administrative exercises that companies in competitive markets do not undertake.

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[62] In its zeal to make a rigorous comparison of rates with and without the CALLS proposal, the APT analysis appears to have lost track of about a $1 per month per account of universal service charges. That is, APT implicitly indicates that USF charges would be $.75 in 2004, when AT&T has already tried to put them at $1.50 and there is at least another $.25 that flows from the CALLS proposal. Compare footnote 7, p. 6 and Figure 1, p. 7, which give the following numbers.

	PRIMARY LINES	
	1999	2004
SLC+ PICC + USF	$5.49	6.90
CALLS SLC + USF	4.52	6.15
IMPLICIT USF	.97	.75

Moreover, to the extent that there is a substantial problem of cost difference between areas, there are other policy mechanisms to address this problem. Deaveraging SLC costs would complicate the calculation of necessary subsidies. It would complicate and perhaps violate the Congressional intention to ensure that rates be reasonably comparable between rural and urban areas. It would certainly make it more difficult for long distance companies to maintain geographically averaged rates, as required by section 254 (g) of the Act of 1996.

Joint Consumer Commentors have strenuously rejected the related suggestion that incumbent LECs be allowed to differentially price before all market segments served from common facilities are fully competitive. Incumbents will certainly use their market power to maximize their profit and competitive position. Residential ratepayers who are certain to be the last group offered competitive alternatives will suffer the greatest loss. Moreover, because access is an intermediate good, not an end product, the exercise of market power through differential pricing will significantly hurt competition.

Texas OPC took this view in the Local Competition proceeding in presenting its critique of Ramsey pricing.

> In no event should the Commission adopt Ramsey pricing as a cost allocation scheme. Ramsey pricing has positive welfare properties only under a very stringent set of assumptions. More importantly, the products should be final products not intermediate goods. Because interconnection services and network elements are intermediate goods, Ramsey pricing may well have negative welfare effects. Indeed, given the critical importance of interconnection services and network elements in the competitive strife between new and incumbent LECs, it is likely that a Ramsey pricing (cost allocation) scheme would weight the balance in favor of incumbent LECs, thus hampering rather than furthering the development of local exchange competition.[63]

[63] OPC Comments, <u>In the Matter of Implementation of Local Competition Provisions in the Telecommunications</u>

Differential pricing in a market that is subject to inconsistent levels of competition should be rejected.

Ultimately, if the Commission does away with the SLC altogether, and guarantees a pass through to consumers of this immediate benefit, it will not have to deal with the problem of deaveraging the SLC.

Respectfully Submitted,

Texas Office of Public Utility Counsel
Consumer Federation of America
Consumers Union

Act of 1996, Docket No. 96-98 (May 16, 1996) p. 27.